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Development Scotland

Spotlight
Scottish Residential Development & Investment

Spring 2012

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This publication

This document was published in March 2012. The data used in the charts and tables is the latest available at the time of going to press. Sources are included for all the charts.

Glossary of terms

■ **Prime:** refers to the most desirable and aspirational property by reference to location, standards of accommodation, aesthetics and value (£400,000 and above). Typically it comprises properties in the top five per cent of the market by house price.

■ **Mainstream:** refers to the bulk of the UK housing market with, for example, price movements monitored by reference to national and regional average values.

■ **Graph 2 datasource:** derived from Savills Development Land Index, based on the quarterly valuation of 1,5 and 30 acre hypothetical greenfield sites.

On the cover: Donaldson's College is a Grade A listed building set in 18 acres in Edinburgh's West End.

Inside: Residential development in Glasgow city centre, Park Lane.

Spotlight
Scottish Residential Development & Investment

The Scottish development industry has made significant progress in the post-credit crunch environment, and prospects continue to improve

Residential development in Scotland has rapidly adapted to an equity-rich, debt-poor operating environment. Housebuilders, developers and investors have re-capitalised and are focussing their efforts on Scotland's higher value housing markets.

Investment in the residential sector has seen increased activity in the last two years, with particular interest in Edinburgh and parts of Glasgow, where capital growth prospects are comparatively strong. Meanwhile, institutional investors are beginning to look to the lower tiers of the market, capitalising on growth in the rental market to deliver income yield.

There are challenges. Housing output remains half of the level prior to the downturn. Many long-term, brownfield sites with remediation issues are unviable, yet are pivotal to the delivery of new homes in Scotland. The debt market remains constrained, and while new sources of private equity are emerging, opportunities are restricted to only the very best sites. Innovative funding models will be required to unlock more sites going forward, drawing on demand from the private rented sector to increase market absorption.

In this document, we explore these challenges and opportunities, and their impact on the Scottish development and investment markets. We set out the state of the Scottish housing market, and look at the availability of debt, the shift to equity, and the adaptations the industry is making in response. We assess the land markets, and the impact new government initiatives may have. We review the state of the residential investment market, and the opportunities it brings. Finally, we look to the future and the outlook for development and investment in Scotland.

Housing market context

House prices in Scotland saw small falls of -0.8% in 2011, though prices stand -10.6% below their 2007 peak, according to the Nationwide index. Transactions are at 56% of their pre-credit crunch highs, in a market that has been characterised by a fundamental shift in its sources of funding.

Since 2008 equity, as opposed to mortgage debt, has become the major source of funding for housing transactions. In 2001, mortgage debt funded 60% of all housing transactions in the UK, by value. By 2011 this

HOUSE PRICES Five-year forecast values

Forecasts	2012	2013	2014	2015	2016	5 years to 2016
Scotland	-4.0%	0.0%	0.0%	0.5%	2.0%	-1.6%
Prime Edinburgh	-2.0%	0.0%	2.0%	4.0%	5.0%	9.2%
Prime Glasgow	-2.5%	0.0%	1.5%	3.5%	4.5%	7.0%

Table source: Savills Research

SUMMARY

New sources of funding

■ Transactional activity in Scotland's land and development markets has increased over 2011. Some high-profile city-centre deals are now being conducted, most notably the ongoing sale of Edinburgh's Quartermile.

■ A shift to equity funding in the housing market means the outlook for prime property in Edinburgh, Aberdeen and parts of Glasgow is positive. Mortgage-driven mainstream markets are less attractive to developers and will continue to lag.

■ This shift has mirrored the development sector itself, where debt funding remains restricted. The industry has responded by tapping into new sources of equity.

■ Scottish Government initiatives such as the National Housing Trust have been introduced to kick-start development activity on stalled sites, while funding has been promised for more affordable homes.

■ Issues remain around the viability and deliverability of large, long term sites, critical to Scotland's strategic housing needs. Sources of long term patient equity, management and market absorption, (only possible via uptake into the private rented sector), may offer the means to unlock these sites.

■ Residential investor activity to date has been focussed on high-value Edinburgh and Glasgow, where rental yields are comparatively low, but capital growth prospects are seen as strong.

■ The private rented sector has grown from 9% of dwelling stock in the early 1990s, to 16% in 2011. We forecast that private renting could account for one in five households by the end of 2016.

■ This marks an opportunity for investors in new high-yielding markets as the private rented sector becomes increasingly dominant.

Government initiatives

Support for the housing sector

The Scottish Government Spending Review sets out plans for completing 30,000 affordable homes by 2015 (5,100 affordable were completed in the four quarters to Q311) through a mix of conventional capital investment and other funding models. February's Scottish housing bill pledged support to the housing sector of £97 million over four years.

This includes an additional £45 million for the affordable housing budget 2015, and £42 million to fund loans and equity investment, including the expansion of shared equity schemes. Part of this will support an 'Infrastructure Investment Loan Fund' which aims to unblock projects. Flexibility and realism in the planning system is also promised, along with a more responsive approach to the identification of new housing sites.

The National Housing Trust, administered by the Scottish Futures Trust, has already secured the delivery of 600 homes across 11 sites around Scotland. This recently extended scheme has proved a mechanism for kick-starting development on stalled sites and ultimately aims to deliver up to 1,000 affordable homes, representing a £100 million investment to the industry.

These initiatives predominantly help to bring mothballed sites into active use, rather than facilitate the development of entirely new supply.

The UK Government has made it clear that it will continue to reduce the funds available to the Scottish Government, especially for capital spending. Therefore, going forward these initiatives will need to be successful in leveraging private sector finance in order to maximise the limited public resources available.

figure stood at 46%. Constraints on mortgage debt have been the main catalyst. Higher loan-to-value mortgages are no longer as readily available (the number of 75%+ mortgages has fallen 67% since 2007), meaning larger deposits are needed to access home ownership.

The shift to equity has had the effect of favouring higher value markets. In Scotland this equates to cities such as Edinburgh and Aberdeen. Here the value of transactions in 2011 stood at 60% and 74% of their 2007/08 highs, respectively, compared to just 44% in Glasgow. Although there too parts of the city, such as the West End, are richer in equity buyers and so have seen significant improvement.

A lack of economic growth at the national level, coupled with continued constraints in the mortgage markets, will result in muted house price growth over the next five years. We anticipate small falls in mainstream Scottish house prices in the five years to 2016, at -1.6%, against 7% in the Prime Glasgow market, and 9.2% in the Prime Edinburgh market, both of which are less reliant on the limited mortgage finance available.

Debt markets

The shift from debt to equity within the housing market has been echoed in sources of funding now being utilised by the development industry. While lending by UK banks to companies active in real estate development and investment saw a small recovery in the first half of 2011, the latest available data points toward further falls in lending, down -£518 million over the third quarter of 2011.

The outlook remains challenging. The Eurozone debt crisis could result in a number of European lenders withdrawing from or scaling back UK activity. Under forthcoming Basel III regulations, a combination of increased capital requirements and minimum liquidity requirements is likely to reduce the return on equity for banks. In order to absorb these additional costs, banks may become less competitive on their lending terms.

The new environment

The latest Home Builders Federation survey for Scotland suggests that developers are beginning to capitalise on new sources of equity funding, and as such are less constrained by the lack of debt funding (see Graph 1).

They are now focussing on smaller development opportunities with lower up-front capital requirements, typically purchasing sites on deferred payment terms. Such developments can be funded from housebuilders' own balance sheets and offer a shorter return on capital employed.

Competition for a shortage of permissioned land is putting pressure on both supply, and in turn prices in the best locations for readily developable sites. Some larger housebuilders are now looking for medium-sized sites in the most viable areas, recognising the importance of securing a pipeline that will offset delays in the planning system.

Viability has risen as a constraint on development in Scotland. In recognition of the constraints the industry faces, the Scottish Government has announced a number of initiatives designed to assist the sector (see box out).

A shift to equity

As a consequence of the debt drought corporate investment buyers are both financing and unlocking development by forward purchasing residential stock. This has been observed in the investment in student blocks in Scotland's university cities, but has yet to spread to build-to-let.

Unlike the buy-to-let investors, active prior to the downturn, these investors appraise their acquisitions with

Edinburgh land market

Interest in new development returns

Transactional activity in Edinburgh's land and development markets has picked up in the last year. Some high-profile city centre deals are now being traded, most notably the sale of Quartermile. This is Edinburgh's largest mixed use scheme and is understood to be under offer to London-based developer and investor Exemplar Properties. The deal is testament to the solid fundamentals of the Edinburgh market.

Edinburgh's Fountainbridge South site, owned by HBOS, has been put under offer to Edinburgh Council for the relocation of Boroughmuir High School to part of the 11.5 acre site. The council is likely to bring forward the mixed use development in a joint venture partnership in phases.

Family housing development sites include the 35 acre Agilent site in South Queensferry with 400 residential units and the now under offer 300 unit site at the former Scottish Water Depot at Fairmilehead. Both sites were recently marketed receiving strong interest from the housebuilder market, reflecting developers' focus on Edinburgh.

Meanwhile, Newcraighall marks the first significant greenfield release in Edinburgh for some time. A resolution to grant Planning Permission in Principle for 336 units as a mix of private and affordable homes has been secured.

Another opportunity currently on the market is the landmark Donaldson's College, a Grade A listed building set within 18 acres in Edinburgh's West End. The site has full planning permission for the refurbishment of the existing college building and the construction of a new build crescent, delivering up to 115 residential units.

reference to income return and rental growth. In some markets, they will make their purchases at substantial discounts to owner-occupied values.

Investors and developers will become less risk averse once there is wider-spread evidence of working models.

Potential areas of flex include the return required by the developer on a partially de-risked scheme, the investor's required return, landowner capacity to share in risk, policy flexibility with regard to planning obligations and efficient management at scale.

Land markets

Land values in Scotland saw modest growth in 2011. Greenfield land values grew by 4.8% over the year predominantly due to strong growth in Edinburgh and Aberdeen, outperforming the UK as a whole, where values increased by 2.5%.

While price growth is sluggish, there are distinct bright spots in the market, with prices of viable, readily developable land rising in many areas where supply is limited, and transaction levels significantly above their 2009 lows.

Housebuilders are targeting their activity, so demand is strong for consented land in high-value regional towns and cities across the country. Aberdeen, where oil industry activity is sustaining surplus household income and demand for new homes, is a strong hotspot. Prices of 1 and 5 acre greenfield sites here have increased in value by 32% in the last year alone, (Graph 2). This has been driven in part by a return to transactional activity, re-setting prices following a period of constrained supply.

The majority of land deals in Scotland since 2008 have been on sites less than 5 acres in size, and accounted for 72% of all deals (Graph 3). Larger, long term strategic sites are not trading in volume, but there are opportunities for organisations with the ability to convert these sites into a de-risked, serviced product appealing to today's market. The value and viability of such land will be realised over a longer time period than smaller sites so, to benefit from value uplift, developers will need to finance over longer time periods.

In light of this, the role of some landowners is changing from raw material supplier to development partner, and even funding partner on longer-term schemes. Under these circumstances housebuilders may need to accept lower margins than when they are taking more direct land risk. Consequently, the mathematics of land value is changing.

Residential investment

The dramatic increase in demand for private rented accommodation since the credit crunch should provide an opportunity for large scale investment in the residential sector, particularly given a lack of activity among buy-to-let borrowers. The private rented sector has grown from 9% of dwelling

GRAPH 1

Constraints on development in Scotland

Graph source: Home Builders Federation

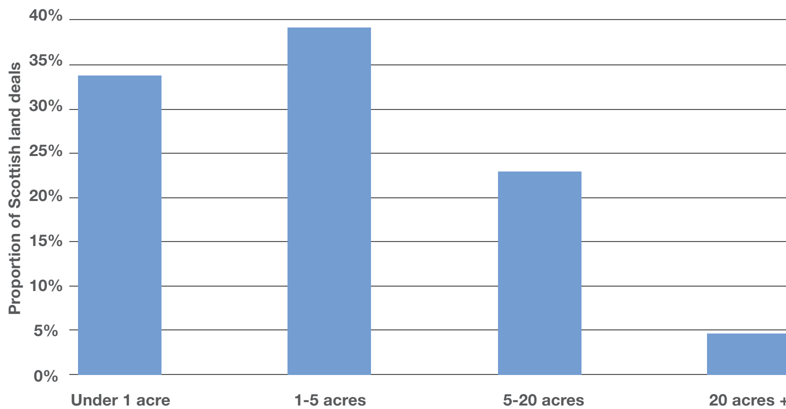
GRAPH 2

Average values per acre, 1 & 5 acre sites, Dec 10 and Dec 11

Graph source: Savills Research

GRAPH 3

Land deals in Scotland 2008 to 2011, by site size



Graph source: Savills Research

"Going forward, more needs to be done to unlock more challenging long-term sites"

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stock in the early 1990s, to 16% in 2011. We forecast that private renting could account for one in five households by the end of 2016.

Equity-rich investors are leading the charge in the conventional residential investment market, but still seek to balance yields with underlying break-up value and effectively acquire with a wholesale discount. We think this practice will decrease as investors concentrate rather more on the creation of long-term income streams.

Most of the residential investment activity in Scotland has been in Edinburgh and parts of Glasgow, where rental yields are comparatively low, but capital growth prospects are strong. Investment here is seen as lower risk.

Savills sale of Heritors' large residential portfolio across Edinburgh and Glasgow is one such example. This portfolio of high value, low yielding traditional properties attracted huge interest from equity-rich investors.

In another Savills brokered deal, the 150 unit Park Lane portfolio in Glasgow was sold to Glasgow Housing Association earlier this year. The portfolio is concentrated in Glasgow City Centre and the West End, and its acquisition marks the Glasgow Housing Association's strategy to diversify into the private rented market, capitalising on strong demand for quality private rented homes in the city.

This move by housing providers who have hitherto only been associated with the social housing sector is expected to increase in the face of falling grant aid from central Government. The private rented sector will increasingly be used to subsidise the affordable sector, and indeed we expect to see a blurring of the line between the two.

Lower income yields continue to constrain large-scale inward investment into the private rented sector, and a longer term, income driven model is yet to be fully established in the private rental sector.

However, the prospect of increased yields in sectors of the market where owner occupiers are set to become much less dominant should pave the way for progressive increases in activity, as rental demand in these areas grows.

We expect localised differences in yields to widen in the future, as constraints on mortgage finance limit the ability of households to buy lower grade properties in secondary or tertiary locations. This is set to push the balance of occupational demand towards renting in such locations, thereby suppressing capital but fuelling rental growth.

OUTLOOK

The market in 2012

■ The Scottish development industry has made significant progress in realigning to the post-credit crunch operating environment. Innovation and targeted activity, in the right locations, have allowed profitable development to take place. Residential investment has re-emerged as an appealing proposition, driven by institutional investors attracted by income growth in the wake of an expanding private rented sector.

■ Going forward, more needs to be done to unlock more challenging long term sites, particularly if Scotland is to see significant increase in housebuilding volumes. Scottish government measures may assist to a degree, but its resources have limits. We expect corporate investment buyers to become more important as buyers of developers' stock. Housebuilders will need to learn how to cater to this market as well as their traditional owner-occupier sector.

■ Given the increasing importance of equity in the market, and its emphasis on shorter-term viability and IRR as a measure of return, development has become difficult on all but the most viable sites, leaving many of the largest, long-term sites unviable.

■ Development economics are already adjusting to the new market reality. Further measures in the form of fundamental changes to the development model are required. Land owners will need to be flexible in their sales agreements, accepting deferred payment terms and sharing in risk.

■ The main barrier to this is finding an alternative model of funding that can break down barriers to long-term, sustainable development. Sources of long-term patient equity, management and market absorption that is only possible via uptake into the private rented sector may offer the means to unlock more of these sites.

Correspondingly, yields are expected to rise progressively, making the lower tiers of the market, in particular, more accessible to large scale investors.

This distinction between high yielding, low capital growth investments and lower yielding higher capital growth investments is already influencing investor behaviour.

We expect this distinction to be a key feature of the market over the next five years, with investors increasingly looking to the lower tiers of the market to deliver income yield and differentiating the investment potential of their stock by grade and location.

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